

# CEPS COMMENTARY



Thinking ahead for Europe

## Corporate Taxation in Europe: Let's get it together!

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*More comprehensive cooperation in corporate taxation at European level could significantly advance the region's socio-economic prosperity, but its potential contribution is unfortunately overlooked in the current search for growth and job creation. Lucrative tax niches established in some member states and the fear of losing fiscal autonomy prevent several countries from accepting the move towards an EU single market for taxation. If 'Lux leaks' and other tax avoidance and evasion revelations succeed in changing the dominant attitudes in the European tax debate, what steps need to be taken to allow tax policy to play a positive role in promoting economic prosperity?*

**L**ux leaks has placed the issue of corporate tax avoidance and evasion once again on the political agenda. In November 2014, the International Consortium of Investigative Journalists<sup>1</sup> unveiled the secret tax deals struck by about 350 multinational companies with the Luxembourg authorities, which allowed them to reduce their corporate income tax (CIT) bill. The companies used mismatches in the tax systems as well as deals with the authorities to reduce both the effective tax rate and the base.

Lux leaks is not the first and is unlikely to be the last tax-avoidance scandal. It followed the public outrage provoked two years earlier in the United Kingdom over reports that the US coffee shop chain Starbucks had substantially reduced its tax bill by paying royalties to its regional headquarters in the Netherlands, which has a regime with low rates on royalties. In turn in the Netherlands, the government-owned national railways attracted public attention when media disclosed that it transferred profits to Ireland to benefit from the lower corporate income tax rate. But Ireland (with 12.5% CIT and attractive intellectual property (IP) regime), Luxembourg (advance agreements) and the Netherlands (IP regime and tax treaties) are definitely not the only EU countries with tax regimes that facilitate tax avoidance. Hence, also Belgium (notional interest deduction and IP regime), Cyprus (12.5% CIT and tax treaties), Estonia (deferral of CIT), Malta (low CIT) and Spain (tax credits and IP regime) are known for having schemes that allow multinationals to lower their tax bill.

The corporate tax evasion is a side effect of the tax schemes that mostly aim to make a country more attractive as a location for (high-growth) foreign companies or to facilitate business-

<sup>1</sup> See [www.icij.org/project/luxembourg-leaks/lux-leaks-revelations-bring-swift-response-around-world](http://www.icij.org/project/luxembourg-leaks/lux-leaks-revelations-bring-swift-response-around-world)

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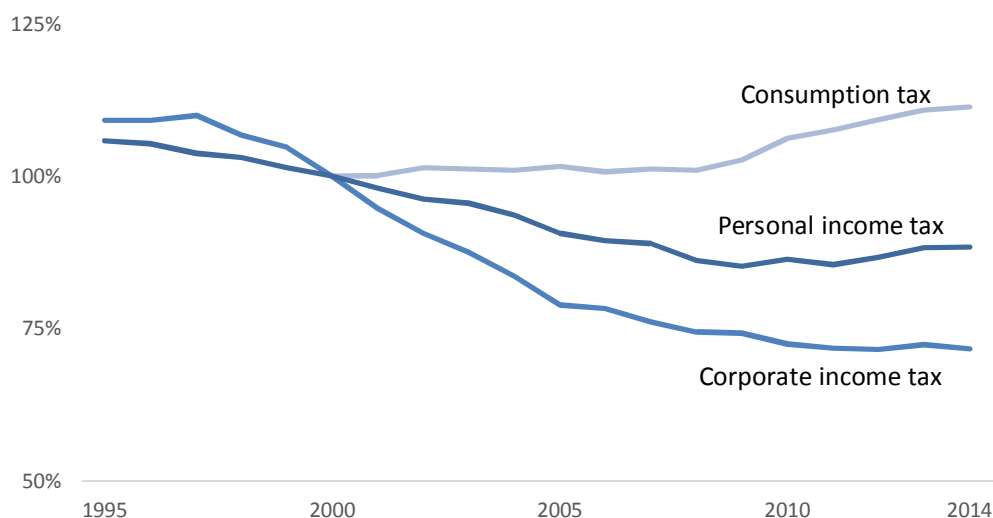
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service industries. This in itself is already distorting, since investments are not necessarily taking place at the locations where they are most efficient. In addition, the competition based on tax schemes presses other member states to make their tax system more attractive for international companies to preserve their competitive position. In fact, in the past two decades, the average top CIT rate has declined almost one-third from 35% in 1995 to 23% in 2014. The variance between the top and bottom rate has further narrowed in the same period by 25-28 percentage points.

In order to make up for the lower CIT-rates, member states need to shift the tax burden to other less-footloose companies or to charge more on rates that are harder to avoid (see Figure 1 for the relative development of various tax rates). These rates are often also more harmful for the economy. The consumption of European citizens, for example, has been hampered in recent years by the increase of the average rate of value added tax (VAT). The top personal income tax rates decreased, but less than would have been possible if a higher (or more effective) CIT could be charged. The higher than necessary labour costs made it less attractive or more difficult for employers to hire new personnel, raise net salaries or improve profitability.

Figure 1. Relative development of tax rates in the EU28 (2000=100), 1995-2014



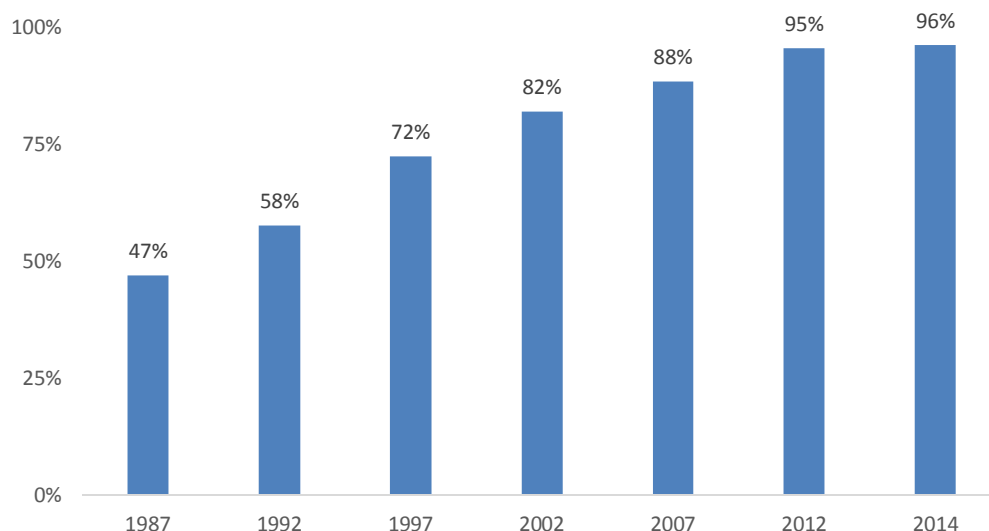
Note: The figure shows the index of the EU28 average (base year=2000) for three different types of tax: consumption tax: standard value added tax (VAT); personal income tax: top personal income tax rate; and corporate income tax: adjusted top statutory tax rate on corporate income.

Source: Author's own calculations based on data from Eurostat (2014).

The corporate tax avoidance today, is primarily the consequence of how taxation been addressed in the European Union in the past. Although a national competence, taxation plays a pivotal role in the correct functioning of the internal market. In the earlier days, however, rather than tax avoidance, it was double taxation that formed the main obstacle. Member states chose to address the double taxation of cross-border activities through bilateral double taxation agreements, which in general prescribe that companies are only taxed in the host-country. Later on, the parent-subsidiary Directive further restricted the maximum CIT rate on a subsidiary's income to the higher of the CIT rate charged in the parent and subsidiary country. The double-taxation agreements and implementation of the parent-subsidiary Directive, which requires companies only to pay corporate tax in the subsidiary's country, allow for some (aggressive) tax planning. In the latter case, the primarily larger internationally

active companies are able to exploit the mismatches between tax systems to reduce both the effective tax rate and base. Figure 2 shows that the coverage of double taxation agreements has gradually increased from 58% in the year of the creation of the Single Market (1992), to almost complete coverage today.

Figure 2. Coverage of double taxation conventions in the EU (changing composition), 1987-2014



Note: The share of total double taxation conventions (DTCs) in the EU is calculated using the number of bilateral DTCs in force in the EU as a share of the maximum possible number of bilateral DTCs between EU member states. Hence, if all 28 member states in the EU in 2014 would have had DTCs with the 27 other member states (i.e. 378 DTCs,) this would be presented as 100% in the figure.

Source: Author's own calculations based on OECD (2015) and Bulgarian National Revenue Agency (2015).

In response to the recent cases of excessive tax avoidance and the global G20-decisions as well as OECD initiatives, the Council has recently adopted two measures. In the meeting on 9 December 2014, it agreed on including a common anti-abuse clause in the parent-subsidiary Directive, aimed at preventing the directive from being used purely to facilitate arrangements to avoid paying taxes. However, since member states are left the option to apply it and the clause is primarily targeting the excesses, it is unlikely to change much. The Council also agreed to strengthen the mandatory automatic exchange of information to prevent taxpayers from hiding taxable capital or assets for the authorities, which is critical in the fight against tax evasion.<sup>2</sup>

But the fundamental flaw in the design, namely the fragmentation in EU tax systems, is still not addressed. Besides facilitating tax avoidance, it also makes cross-border activities more expensive than necessary. Companies need to declare their tax in all member states where they are active instead of only their home country. This administrative burden weighs in particular on companies with smaller foreign activities. In fact, the taxation requirements might even restrain smaller businesses from conducting cross-border activities at all.

More coordination at international is thus required to make sure that all corporate profits are taxed only once and undertaking cross-border activities in the EU becomes less burdensome. The initiatives taken at global level have so far proved to be unsuccessful, but this should not discourage the EU from deepening the tax cooperation within its own borders. The European Commission's proposals to enhance the coordination have failed in the recent decades.

<sup>2</sup> See [www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/146136.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/146136.pdf)

Nevertheless, the most recent proposal for a Common Consolidated Corporate Tax Base (CCCTB) could be brought forward again. The 2011 European Commission proposal foresees a single set of rules to determine the tax base covering all EU member states, which would allow companies to declare CIT at consolidated level. In turn, the member states can still set their own rates for their share of the profits. Nevertheless, the CCCTB should become obligatory for all companies (with cross-border activities) and not optional, as currently proposed, to eliminate the arbitrage possibilities. Moreover, further action will still be required to avoid the usage of third-countries for tax avoidance and evasion as well as to address the differences in accounting standards between companies using IFRS and the various local GAAPs.<sup>3</sup>

The European Parliament might prepare the ground for challenging the status quo in corporate taxation discussions. It has recently taken a more active role in this dossier by setting up a special committee on tax avoidance.<sup>4</sup> Although less resolute than the committees of inquiry demanded by a large minority in the Parliament, the committee could still broaden general awareness of the harmfulness of corporate tax avoidance and evasion as well as create a sense of urgency of the need for Europe to move towards a consolidated corporate tax. In the meantime the European Parliament could broaden its earlier demands for public disclosure of the country-by-country corporate tax bill, which would provide better insights into the frequency and magnitude of tax avoidance and allow customers to hold companies accountable for the morality of their tax behaviour.

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<sup>3</sup> See M.P. Devereux and C. Fuest (2009), "Corporate income tax coordination in the European Union", *Transfer: European Review of Labour and Research*, 16(1), 23-28 [http://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Policy\\_Papers/TransferPolicydocumentVersion0311Website.pdf](http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Policy_Papers/TransferPolicydocumentVersion0311Website.pdf).

<sup>4</sup> See [www.europarl.europa.eu/news/en/news-room/content/20150206IPR21203/html/Parliament-sets-up-a-special-committee-on-tax-rulings](http://www.europarl.europa.eu/news/en/news-room/content/20150206IPR21203/html/Parliament-sets-up-a-special-committee-on-tax-rulings)